

**CONSTRUCTION/REAL ESTATE INDUSTRY  
COORDINATED ISSUE  
CLAIM REVENUE UNDER A LONG-TERM CONTRACT  
460.02-04**

**ISSUE**

Whether the contractor-taxpayer must include "claim revenue" (also referenced by the regulations as "contingent compensation") in the total contract price in determining the gross income from a long-term contract under I.R.C. § 460 in the taxable year when additional work is performed.

**FACTS**

Contractor enters into a "long-term contract" (as defined under section 460(f)) with a client for the building, installation, or construction of property, scheduled for completion three years later. The contract does not involve home construction, and contractor's average annual gross receipts for the immediately preceding three taxable years exceeded \$10,000,000.

During the course of construction, contractor performed additional work and incurred additional costs attributable to customer caused delays, errors in specifications and designs, unpriced change orders, or other unanticipated work. The contractor deducted these costs for tax purposes. Although client agreed to the additional work, the parties had not agreed to a price for the extra work performed. The parties will negotiate the price at a later time. The contract provisions dealing with change orders provide a legal basis for a claim under contract law in the controlling jurisdiction.

In determining the amount of gross income from the contract under section 460 for the taxable year at issue, the contractor used the original contract price in the section 460 computation. Contractor did not increase the total contract price, for purposes of section 460, for the revenue attributable to the additional work performed during the taxable year ("claim revenue").

For book purposes, however, contractor accrued additional income attributable to the additional work performed in accordance with the Accounting Standards Division of the American Institute of Certified Public Accountants Statement of Position 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" (AICPA SOP 81-1). Paragraph 65 of AICPA SOP 81-1 establishes a standard for revenue recognition for claims:

Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

- a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not a result of deficiencies in the contractor's performance.
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
- d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

Paragraph 66 of AICPA SOP 81-1 allows an alternative to the above in that the contractor may defer recording revenue from claims until they have been received or awarded. If that practice is followed, the amounts should be disclosed in the financial statements.

## **DISCUSSION**

Section 460(a) generally requires the determination of gross income from any long-term contract under the percentage of completion method of accounting (PCM). Section 460(b) describes PCM as a two-step process. First, the taxpayer must annually determine the amount of gross income for each taxable year of the contract. I.R.C. § 460(b)(1)(A). Second, upon completing the contract, the taxpayer must compute the amount of look-back interest that is payable on hypothetical underpayments of tax, or receivable on hypothetical

overpayments of tax, for each year during the life of the contract. I.R.C. § 460(b)(1)(B).

Under PCM, income from a long-term contract must be reported over the life of the contract, and expenses must be deducted in the year incurred. The reportable gross income for each taxable year ending after the date the contract was entered into is calculated as follows: The total cumulative costs allocable to the contract incurred to date are divided by the total costs allocable to the contract that the taxpayer expects to incur and then multiplied by the total contract revenue that the taxpayer expects to receive (total contract price). The product of this multiplication is reduced by the contract gross income required to be reported in all preceding taxable years. See I.R.C. § 460(b)(1)(A); Notice 89-15, 1989-1 C.B. 634, 640-41 Q&A-19 and 20. The costs allocable to the contract are allowable as deductions from gross income in computing taxable income in the year in which such costs are incurred. See Notice 89-15, 1989-1 C.B. at 642, Q&A-32; see also Treas. Reg. § 1.460-4(b) (for long-term contracts entered into after January 10, 2001.)

The total amount of revenue that a taxpayer estimates it will receive with respect to the long-term contract is included in the total contract price for the computation of PCM. See 1989-1 C.B. at 640, Q&A-19. The total contract price is not a static amount. The amount may vary for each year of the contract. Also, amounts received or to be received by a taxpayer from a client as reimbursement for costs in performing a long-term contract are included in the total contract price. See 1989-1 C.B. at 642, Q&A-31. A taxpayer must make a reasonable estimate of the total contract revenue it expects to receive from a long-term contract based on the facts available on the last day of each taxable year of that contract. Events that occur after the end of the taxable year that were not reasonably subject to estimate as of the last day of the taxable year are not taken into account. See 1989-1 C.B. at 641, Q&A-24.

For long-term contracts entered into after February 28, 1986, Treas. Reg. § 1.460-6(c)(2)(vi)(A) treats claim revenue amounts as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all events test has not been met. T.D. 8315, Oct. 15, 1990.

[A] portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

Treas. Reg. § 1.460-6(c)(2)(vi)(B). Thus, the total contract price includes any amount the taxpayer reasonably expects to receive from the client under the

contract.

Treas. Reg. § 1.460-4(b)(4)(i)(B), also applicable to long-term contracts entered into after January 10, 2001, defines "contingent compensation" as any amount related to a contingent right under a contract, such as a bonus, award, incentive payment, and amount in dispute. The PCM taxpayer includes contingent compensation in the total contract price as soon as the taxpayer can reasonably predict that it will earn the amount, even if the all events test has not been met. A taxpayer can reasonably predict that it will earn a contingent income amount not later than when the taxpayer includes that amount in income for financial reporting purposes under generally accepted accounting principles. Id.

Before the effective date of Treas. Reg. § 1.460-4(b)(4)(i)(B) cited above, the Tax Court rejected the "all events test" for purposes of estimating contract price. In Tutor-Saliba Corp. v. Commissioner, 115 T.C. 1 (2000), a taxpayer challenged the validity of Treas. Reg. § 1.460-6(c)(2)(vi)(A) and (B) because the regulation did not require that disputed long-term contract claims meet the all events test to be included in the estimated contract price. The Tax Court rejected the taxpayer's contention. The Court found that the percentage of completion method under section 460 is the method Congress chose for reporting long-term contract income in order to modify income deferral previously permitted. The taxpayer must include an estimate of disputed claims in the total contract price as soon as it reasonably expects to receive them. Moreover, the statute calls for the use of "estimated" contract price and costs. Because the all events test does not recognize income until it is fixed and determinable, requiring the all events test would render moot any "estimating" of the total contract price and lead to additional timing differences (income deferrals) which would likely require taxpayers to pay more look-back interest. See 115 T.C. at 12-14.

Regardless of whether the long-term contract was entered into after January 10, 2001 or before January 11, 2001, Notice 89-15, 1989-1 C.B. at 642, Q&A 27, continues to apply, which provides that:

All amounts that the taxpayer is or will be entitled to receive from the customer under the contract, or any other rule of law (including, for example, the contract law rule of quantum meruit, or other quasi-contractual remedies) must be included in total expected contract revenues . . .

Applying the above rules to facts in this case, during the year when the contractor performed additional work and incurred additional costs, the contractor has underestimated the total contract revenue it expects to receive from the contract, i.e., the total contract price, in determining the amount of its gross income from the contract, by the amount of the claim revenue. The claim revenue is the amount of the additional revenue the contractor should have reasonably expected to be due on the contract from performing the additional

work. In general, since expected quantum meruit recoveries are included in gross income, this amount should not be less than the contractor's cost of performing the additional work.

As a preliminary matter, the contractor incurred additional costs based on the client's authorization to perform the additional work. Although the parties did not discuss price, the contractor probably would not have performed the additional work if it knew or expected it would not be paid or reimbursed for at least its additional costs. See Notice 89-15, 1989-1 C.B. at 642 Q&A 31 (expected cost reimbursements included in total contract price). (The construction contractor has conflicting objectives to not only adjust contract performance to solve problems encountered in the construction, but also to maintain a steady pace to meet the projected completion date. The contractor cannot shut down construction each time there is a change order to assure timely payment.) Even if the client had disputed the price, it would be highly likely that the contractor would be due at least its costs under some express or implied contract theory of recovery. See Notice 89-15, 1989-1 C.B. at 641 Q&A 27 (total contract price includes amounts the taxpayer reasonably expects to receive under the contract and any other rule of law).

Finally, the contractor accrued income for book purposes equal to the amount of costs it incurred for the additional work in that year pursuant to AICPA SOP 81-1. Although strict financial conformity is not required for tax purposes, the taxpayer's accrual of revenue for financial reporting purposes attributable to the additional work authorized by the client strongly indicates that the taxpayer could reasonably estimate the amount of contract revenue to be received. For long-term contracts entered into after January 10, 2001, Treas. Reg. § 1.460-4(b)(4)(i)(B) requires tax recognition no later than when the taxpayer included the amount in income for financial reporting purposes. The absence of accrued revenue for book purposes, however, does not establish for tax purposes that the taxpayer could not reasonably estimate the amount of contract revenue attributable to the additional work.

## **CONCLUSION**

The facts here indicate that, at the end of taxable year in which the contractor performed the additional work, it was reasonable to conclude that the contractor was entitled to be paid for the additional work. The contractor must include "claim revenue" in the total contract price in determining the gross income from a long-term contract under section 460 for the taxable year when the additional work was performed. The claim revenue should not be less than the contractor's cost of performing the additional work. Upon contract completion, the contractor must compute and report look-back interest payable on hypothetical underpayments of tax or look-back interest receivable on hypothetical overpayments of tax under I.R.C. § 460(b)(1)(B).